Office of Chief Counsel
Internal Revenue Service
memorandum
CC:LM:RFP:CHI:M:POSTF-145251-01

date: March 11, 2002

to: Compliance Division
Attn: Marvin D. Svacina, Revenue Agent, LMSB 1172

from: Associate Area Counsel (LMSB), Chicago

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subject: [redacted], **Inc. (f/k/a** [redacted]
Contingent Liability Tax Shelter, [redacted]

EIN: [redacted]

This memorandum is a revision of the written advice we gave you on February 11, 2002, which was a response to your request for assistance dated August 15, 2001.

In your memo you asked whether the taxpayer's claimed capital loss arising from an arrangement designed to shift liability for unfunded deferred compensation liabilities should be disallowed. In our opinion of February 11, we stated that the arrangement is a contingent liability tax shelter and should be disallowed. We repeat that advice here. In our memorandum of February 11, however, we stated that one reason for disallowance was Treas. Reg. § 1.1502-20. Treas. Reg. § 1.1502-20 should not be cited in disallowing the item at issue.

We believe that some penalties are appropriate, as discussed below.

We contacted industry counsel Rose Gole, Office of Area Counsel (LMSB), Long Island, who on January 25, 2002, provided valuable input in the writing of the February 11 memorandum. This revised memorandum is based in part on input from Mark J. Weiss and Theresa Abell of Chief Counsel.

This memorandum should not be cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

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Facts

The transactions which give rise to this request for advice took place in [redacted] and [redacted]. The taxpayer and associated companies underwent name changes at about the same time. The description of the parties in the following paragraph therefore includes both their current and former names. Later in this memorandum, however, we will refer to the companies by their former names only, as those are the names used in the documents evidencing the transactions at issue.

The [redacted] Company (formerly known as [redacted] is a [redacted] corporation. It is the sole owner of [redacted] Inc. (formerly known as [redacted], Inc., hereinafter "[redacted]" or "the taxpayer"). [redacted] is a holding company that filed consolidated life, non-life income tax returns for [redacted], [redacted] and [redacted], all of which are currently being examined by the Compliance Division. [redacted] is the sole owner of several life insurance companies, including [redacted] Company (formerly known as [redacted] Company, hereinafter "[redacted]"). [redacted] is the sole owner of [redacted] ("[redacted]" or "[redacted]") and [redacted] (formerly known as the [redacted] Corporation or "[redacted]"). The corporate structure is illustrated by the following chart:

[redacted]
(f/k/a [redacted])

[redacted] (f/k/a [redacted]) (holding company)

[redacted] Co. (f/k/a [redacted])

Other life insurance companies

[redacted] a/k/a [redacted]

[redacted] (f/k/a [redacted])

The taxpayer's financial statement for [redacted] lists [redacted] as "dormant." [redacted] was incorporated in [redacted] but had no substantial assets or business operations prior to the "restructuring" at issue. After the restructuring, [redacted] operated as a "benefits management company."

Before the restructuring, [redacted] and its parent were liable for substantial unfunded employee benefits ("the liabilities"). [redacted] wished to transfer these liabilities, allegedly to better manage the liabilities and to improve the company's balance sheet (and thus its insurance industry rating).

The restructuring was factually complex. On [redacted], [redacted] and [redacted] transferred valuable marketable securities and cash to [redacted] in exchange for "cash intercompany debentures" (i.e., two promissory notes payable by [redacted] to [redacted] or [redacted]).[1] The face amount of the promissory notes totaled $[redacted]. These notes have identical terms.[2] The face value of the marketable securities and cash was equal to the face value of the promissory notes. On [redacted], [redacted] and [redacted] transferred the promissory notes described above to [redacted] in return for [redacted]'s newly-issued preferred stock and [redacted]'s assumption of the liabilities ("the transfer"). [redacted] assumed the duty to pay the liabilities as they became due and to indemnify [redacted] and hold [redacted] harmless from these liabilities. At the time of the transfer, the estimated fair market value of the liabilities assumed by [redacted] was $[redacted], the fair market value of the promissory notes was put at $[redacted], and the fair market value of the [redacted] preferred stock was put at $[redacted].[3] On [redacted], [redacted] and [redacted] sold their [redacted] preferred stock to

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[1] [redacted] issued these notes, with a face value of $[redacted], in exchange for an equal amount of cash paid to [redacted] by [redacted] and [redacted]. Prior to the receipt of this cash, [redacted] had virtually no assets. The cash was invested in apparently legitimate investments. [redacted] is reported in the annual statement for [redacted] as "dormant."

[2] There are two notes: One for $[redacted] and the other for $[redacted]. In both notes [redacted] promises to pay to [redacted] or [redacted] the principal plus interest at [redacted]% annually for [redacted] years. Prepayment may be made at any time without penalty.

[3] Shortly after the transfer, certain minor adjustments were required due to actual payments which occurred through [redacted], which were not reflected in the original fair market value estimate of the liabilities.

a subsidiary of the [redacted] ("[redacted]") in a private placement. The taxpayer does not appear to have any ownership or control over the [redacted] or its subsidiaries. At the time of the transfer, [redacted] and [redacted] had no binding contractual commitment to sell the preferred stock. The sale to the [redacted] subsidiary included indemnities to prevent loss to the [redacted] and stated that if the Internal Revenue Service disallowed the transaction then the sellers [redacted] and [redacted]) would pay any additional tax due. On the sale to the [redacted], [redacted] and [redacted] claimed a short term capital loss of $[redacted]. They also claimed deductible expenses of about $[redacted] in connection with this transaction.

In a letter from [redacted] dated [redacted] that firm gave its legal opinion regarding the restructuring described above.[4] At pages [redacted] and [redacted] of that letter, [redacted] states that: [redacted]. The taxpayer prepared its returns in accordance with this advice.

The letter (at pages [redacted] to [redacted]) also describes in detail the alleged business purpose of the restructuring. The letter states that the purpose of the restructuring is to increase the company's surplus for statutory accounting purposes (and thereby

[4] Although this letter was written over [redacted] months after the companies changed their names, the letter refers to the companies only by their former names.

obtain a better rating from insurance company rating agencies), to better manage benefits for an expanding payroll, and to "maximize the performance of [redacted]'s investment portfolio."

Issues

(1) Given the above facts, can the taxpayer claim a short-term capital loss on the sale of stock of [redacted], a subsidiary corporation to which it transferred contingent liabilities?

(2) Are penalties appropriate under I.R.C. § 6662 (accuracy related), § 6694 (return preparer), § 6700 (promoter penalty), § 6701 (aiding and abetting), and § 6707 (failure to furnish information regarding tax shelters)?

Law

I.R.C. § 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and, immediately after the exchange, such person or persons are in control of the corporation.

I.R.C. § 351(b) provides that if § 351(a) would apply to an exchange but for the fact that there is received in addition to the stock permitted to be received under section 351(a), other property or money, then gain (if any) to such recipient shall be recognized, but not in excess of the amount of money received plus the fair market value of such other property received, and no loss to such recipient shall be recognized.

I.R.C. § 357(a) provides that, except as provided in I.R.C. §§ 357(b) and (c), if the taxpayer-transferor receives property that would be permitted to be received under § 351 without the recognition of gain if it were the sole consideration (i.e. the stock of the transferee corporation) and, as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption or acquisition shall not be treated as money or other property and shall not prevent the exchange from being within the provisions of § 351.

I.R.C. § 357(b) provides that if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in § 357(a) was a purpose to avoid federal income tax on the exchange, or if not such a purpose, was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the taxpayer on the exchange.

I.R.C. § 357(b)(2) provides that the burden is on the taxpayer to prove by the clear preponderance of the evidence that such assumption is not to be treated as money received by the taxpayer.

I.R.C. § 357(c)(1) provides that, in the case of an exchange to which § 351 applies, if the sum of the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

I.R.C. § 357(c)(2)(A) provides that § 357(c)(1) shall not apply to any exchange to which § 357(b)(1) applies.

I.R.C. § 358(a)(1) provides that, in the case of an exchange to which § 351 applies, the basis of property permitted to be received under such section without the recognition of gain or loss (i.e. the stock of the transferee corporation) shall be the same as that of the property exchanged, decreased by the fair market value of any other property received by the taxpayer, the amount of money received by the taxpayer, and the amount of loss to the taxpayer that was recognized on the exchange, and increased by the amount that was treated as a dividend and the amount of gain to the taxpayer which was recognized on such exchange.

I.R.C. § 165 allows a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

I.R.C. § 6662(c) and (d) impose a penalty of 20% of any portion of an underpayment which is attributable to negligence or disregard of rules or regulations, or for any substantial understatement of income tax.

I.R.C. § 6662(h) imposes a penalty if a portion of a tax underpayment is attributable to one or more gross valuation misstatements.

I.R.C. § 6700 imposes a penalty on any person who promotes an abusive tax shelter. I.R.C. § 6701 imposes a penalty on any person who aids in filing a return, knowing (or having reason to believe) that the return would result in an understatement of tax liability for another person. I.R.C. § 6707(a) provides a penalty for any person who is required to register a tax shelter and fails to do so. I.R.C. § 6694 imposes a penalty on certain return preparers.

Analysis

We believe that the capital loss claimed by the taxpayer is not allowable for various reasons described below and that consideration should be given to imposing penalties under I.R.C. § 6662(c), (d) and (h). We emphasize, however, that further factual development is necessary if the adjustment is to be sustained through the Appeals and litigation process.

As discussed below, penalties under §§ 6700, 6701, and 6707 may also be appropriate but would require the opening of a separate case file regarding the promoter and the investment of considerable resources by your division.

Issue (1): Short Term Capital Loss

The problem presented is discussed thoroughly in Notice 2001-17. That Notice describes transactions

> that involve the transfer of a high basis asset (i.e., an asset with a basis that approximates its fair market value) to a corporation purportedly in exchange for stock of the transferee corporation, and the transferee corporation's assumption of a liability (such as a liability for deferred compensation or other deferred employee benefits . . .) that the transferor has not yet taken into account for federal income tax purposes. The transferor typically remains liable on the underlying obligation. The basis and fair market value of the transferred asset, which may be a security of another member of the same affiliated group of corporations, are generally only marginally greater than the present value of the assumed liability. Therefore, the value of the stock of the transferee received by the transferor is minimal relative to the basis and fair market value of the asset transferred to the transferee corporation. . . .
>
> The transferor typically sells the stock of the transferee corporation for its fair market value within a relatively short period of time after the purported § 351 exchange and claims a tax loss in an amount

approximately the present value of the liability assumed by the transferee corporation.

The Notice concludes that, for transfers on or before October 18, 1999 (the effective date of I.R.C. § 358(h)), some of the reasons the Service will disallow such losses are:

(1) that the purported § 351 exchange lacks sufficient business purpose to qualify as a § 351 exchange;

(2) that the transfer of the asset to the transferee corporation is not, in substance, a transfer of property in exchange for stock within the meaning of § 351;

(3) that the purported § 351 exchange constitutes an acquisition of control of the transferee corporation for the principal purpose of tax avoidance within the meaning of § 269(a);

(4) that the principal purpose of the transferee's assumption of the liability was a purpose to avoid federal income tax or was not a bona fide business purpose within the meaning of § 357(b)(1);

(5) that the purported loss on the sale of the stock of the transferee corporation is not a bona fide loss actually sustained by the transferor as required by Treas. Reg. § 1.165-1(b); and

(6) that the overall transaction lacks sufficient economic substance to be respected for income tax purposes, as described in ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998). The notice also states that penalties under I.R.C. 6707(a) and 6708(a) may be appropriate.

It is apparent that many of the facts of your case are similar to the facts in Notice 2001-17. The unfunded employee benefit liabilities appear to be "liabilities" within the meaning of I.R.C. § 357(c) and were "assumed" by [redacted] within the meaning of I.R.C. § 358.[5] The taxpayer's purported statement of business purpose and the indemnification against loss to the bank indicate that the taxpayer's principal purpose for this reorganization was

[5] I.R.C. § 358(h) is effective only for assumptions of liabilities on or after October 19, 1999, and therefore does not apply to this case.

not a bona fide business purpose. Without a bona fide business purpose, § 357(b)(1)(B) would apply to treat the assumption of liabilities as money received (for purposes of § 351) by [redacted] and [redacted] on the exchange. Section 358(a)(1)(A)(ii) would then apply to reduce the basis in the transferee stock by the amount of the deemed money received. [redacted]'s subsidiary (and thus [redacted] through the consolidated returns) would remain entitled to take the deductions arising from payment of the liabilities as they become due. Therefore, § 358(d)(2) does not apply and [redacted] and [redacted]'s basis in the stock must be decreased by the amount of the liabilities assumed.

Furthermore, the loss claimed by the taxpayer on the sale of the preferred stock is not a bona fide economic loss representing a real change of position in a true economic sense, and therefore is not allowable under I.R.C. § 165. Scully v. United States, 840 F.2d 478 (7th Cir. 1988).

The contingent liability issue is further amplified in Notice 2001-033 and the revised version thereof, Notice 2001-033a. This notice repeats that the transfer of the asset in exchange for stock does not qualify as a section 351 exchange, and that even if the transaction qualified as a section 351 exchange that the basis of the stock is less than the basis of the asset transferred because it is reduced by the amount of the assumed liability.

On the other hand, the taxpayer obviously intends to argue that there was a business purpose to the arrangement and has submitted a lengthy memorandum supporting that argument. We therefore recommend that you develop the facts as much as possible on this issue. For example, you should seek information and documents needed to determine if the taxpayer satisfied its alleged objectives, to establish how the taxpayer treated the transaction for insurance regulatory purposes, and to find the explanations for the transaction (including the ostensible capital loss) that the taxpayer presented in its audited financial statements and insurance regulatory filings.

As the taxpayer states that the "restructuring" enabled [redacted] to act as a "benefits management company," inquiries should be made as to any real changes in the handling of the employee benefit liabilities subsequent to the "restructuring," including changes in staffing or payroll. Obviously, a lack of real change in the management of the liabilities, or the existence of ancillary agreements which effectively restored responsibility for the management of the liabilities to the parent corporation would strengthen our case.

Third-party factual development should be pursued to establish what compensation, if any, the [redacted] received for participating in the transaction, and what negotiations were undertaken between the bank, the taxpayer, and the accounting firm regarding this transaction. You should also attempt to discover the details of the indemnification agreement protecting the bank and whether there were put and call options or other stock restrictions.

The above development will be essential in supporting the adjustment that you propose.

Issue (2): Penalties

The penalty for substantial understatement under I.R.C. § 6662(d) depends on an arithmetical calculation. The penalty applies if the amount of tax understatement for a given year exceeds the greater of $5,000 or ten percent of the tax required to be shown on the return. If your calculations indicate that this threshold has been reached, then we approve of imposing this penalty on this taxpayer.

The accuracy-related penalty under I.R.C. § 6662(c) ("negligence") applies if the taxpayer has failed to make a reasonable attempt to comply with the provisions of the Code. Based on the facts provided, this section also applies and we recommend that the penalty be imposed on the taxpayer on account of negligence.

Under I.R.C. § 6662(h) a penalty can be imposed in the event of gross valuation misstatements. If your calculations indicate that this penalty applies then we recommend that it should be imposed as the Service's primary position (with the two above-mentioned penalties as alternative positions) since the penalty under § 6662(h) would be the greater dollar amount.

According to Notice 2001-17, penalties may be appropriate against an accountant-promoter. These penalties are imposed under I.R.C. §§ 6700, 6701, and 6707. In addition, I.R.C. § 6694 provides for a penalty against a return preparer who has made a claim in a return based on a position for which there was not a realistic possibility of being sustained on the merits, the preparer knew or reasonably should have known of the position, and the position was not disclosed as provided or was frivolous. In our opinion, all these penalties may be appropriate to impose on [redacted] in this case. As an internal matter, however, such penalties can be imposed only if a penalty investigation is opened on the accountant-promoter separate from the examination of the taxpayer. Furthermore, substantial factual development would have to be made to support these penalties. Whether you wish to pursue such penalties therefore depends largely on the amount of resources which the Compliance Division chooses to devote to the matter.

Conclusion

We conclude that the taxpayer's claimed losses should be disallowed for the seven reasons listed above in our description of Notice 2001-17, except for the reason based on Treas. Reg. § 1.1502-20.

We also conclude that the penalty for gross valuation misstatement, the accuracy-related penalty (negligence) and, if the figures support it, the substantial understatement penalty (all under I.R.C. § 6662) are appropriate against the taxpayer. Penalties against [redacted] may be appropriate under I.R.C. §§ 6694, 6700, 6701, and 6707 depending on further development.

The facts presented in FSA 2001-21013 and FSA 2001-34008 are very similar to the facts of the present case and the law and logic discussed in those FSAs are very useful in understanding the issues raised in the present case. Both FSAs, relying upon Notice 2001-17, concluded that the claimed capital loss was not allowable. We note that a field service advice cannot be cited as precedent but these FSAs may be useful in writing your Explanation of Adjustments.

Of course, this advice depends on the facts which you have presented and we caution you not to apply this advice to other taxpayers. If you have any questions or need further advice, please contact J. Paul Knap at 414-297-4246.

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